Benny B M Popoitai: Prospects for development and economic growth in the new decade

Address by Mr Benny B M Popoitai, Deputy Governor Regulations of the Bank of Papua New Guinea, to the Papua New Guinea-Australian Business Council Forum, Townsville, Queensland, Australia, 16-18 May 2010.

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Papua New Guinea (PNG) Minister for foreign affairs, Honourable Sam Abal, MP, Australian High Commissioner to PNG, His Excellency High Commissioner Mr. Ian Kemish, PNG's High Commissioner to Australia, His Excellency High Commissioner Mr. Charles Lepani, the two presidents of the Australia-PNG Business Council, distinguished guests, ladies and gentlemen. I wish to thank the organizers for having invited the Bank of PNG, particularly the Governor, to make a presentation at this forum. I pass the Governor's apology for not being able to make it to the forum due to other commitments. I am standing in for him.

In the Bank of PNG's Monetary Policy Statement (MPS) of 31st March 2010, the Governor outlined the monetary policy stance the Bank will pursue in the first half of this year and the medium term. Two points were stressed: that the Bank, in its application of monetary policy, will carefully assess and evaluate the trade-off between higher economic growth and inflation so as not to discourage domestic economic activity and ensure inflation does not spiral out of control; and that only prudent fiscal management of the windfall revenue from the LNG project and close cooperation and coordination between the Central Bank and the Government will make it possible for monetary policy to address inflationary concerns in 2010 and the medium term when the private sector will be driving economic growth. These will ensure that macroeconomic stability is maintained, which in turn will provide the foundation for Papua New Guinea to fully utilize and Papua New Guineans to use all the opportunities the development of the Liquefied Natural Gas (LNG) project is offering.

Today, my presentation will be on:
1. The lessons we can learn from our history on economic management;
2. Current State of the Economy;
3. What are the development prospects of the construction and operation of a LNG project?; and
4. What should be done to ensure that this time around we achieve our development objectives?

1. The lessons we can learn from our history on economic management

As we all know, history can be a good teacher if we are willing to learn from it.

The Government's expansionary fiscal policy and its reliance on monetary policy for debt management, during the period between the outbreak of the Bougainville conflict in 1989 and 1999 resulted in what can be best defined as the "Lost Decade". Instead of taking full advantage of the very substantial income flows from the mineral developments and investing them in improving the social areas of health, education, physical infrastructure maintenance and construction of roads, airstrips, sea and river ports to open up the rural areas to markets, and law and order the resources were squandered and wasted. In the early 90's the misguided policies of the Government of the day by reducing taxes and increasing the recurrent expenditure, at a time when the country was in a major, very costly armed conflict, resulted in the loss of public confidence, a run on the Kina and a state of insolvency after loosing all its foreign exchange reserves.

In June 1995 the Organic Law on Provincial and Local Level Governments was passed, shifting the fiscal operations of the Government from a centralized to a decentralized model. While well-intended, the change placed a further demand on the very strained resources of the National Government. The transfers of funds from the National Government to the Provincial and Local Level Governments was aimed at funding the transferred functions, in health, education, law and order and infrastructure. While the funds were transferred the functions stayed with the National Government and left unfunded. Not surprising the result was that the social indicators worsened and the infrastructure of the country deteriorated. In some parts of the country they have become unusable.

Looking at the numbers in the "lost decade" after the very strong growth in the 1991 to 1993 period, the rest of the period to 1999 has had an annual decline in growth of negative 1.1% on per annum. The result was that for the whole period from 1989 to 1999, a period when some of Papua New Guinea's very large mineral developments took place, the per capita growth in GDP was negative 1.6%.

The period from 2000 to 2006 can be defined as a period of consolidation after the restoration of responsible macroeconomic management. Fiscal responsibility was reestablished. The understanding that any increase in public debt places an unsustainable burden on the National Purse was accepted by all policy makers. Even more so, the need for close cooperation and coordination between the fiscal operations of the Government at all levels and monetary policy management, the sole responsibility of an independent Central Bank with a clearly stated prime objective of Price Stability, are the necessary conditions for a long term broad based economic development and growth. The annual growth in GDP was 2.62% and with an annual population growth rate of 2.83%, the per capita growth in GDP was negative 0.0021% per annum. It is within the range of the statistical error, and therefore it is zero. This is still a poor performance but it is an improvement from the 1990s.

It is only in the last three years, 2007 to 2009, that we have had an overall growth in GDP of 21.5% or a per annum growth of 6.6% and a per capita growth rate of 3.77% per annum.

The conclusions are very clear. In the thirty four years of our independence, we have failed in the overall objective to increase the standard of living and well-being of the great majority of our people. The statistical information we have shows that for the whole period the per capita income declined by around 4% and social indicators indicate a dismal performance, this with two periods of very strong GDP growth, the first at the mineral boom in 1991 to 1993 driven by the construction and increase in the volume of exports from Misima, Porgera and Kutubu and the second from 2006 to 2009 driven by unprecedented price increases of oil, copper and gold.

2. Current state of the economy

Papua New Guinea has, over the last 7 years, with a blip in 2009, benefited significantly from the export commodity price boom as it resulted in fiscal surpluses, record international reserve levels, reduced total public debt and sustained real GDP growth. The financial sector reform, which commenced in 2000, contributed to a sound and prudently managed financial system and aided economic growth.

The sound and prudent management of our financial institutions is reflected by the high capital adequacy ratios, a liquid banking system, low level of non-performing loans, and funding of loans by the banking system from deposits rather than from borrowings from overseas. The Central Bank authorized financial institutions also remained highly profitable. A further testament of the sound financial system was when the economy withstood the global financial crisis. Through good management our financial institutions had less exposure to the troubled markets and institutions abroad.

Prudent monetary and fiscal policies between 2003 and 2009, with the exception of 2008, and a co-ordinated approach in their management also contributed to stable exchange rates and price stability (low inflation in the single digits) and improved confidence in the domestic economy. Together with the low interest rate environment, this led to a significant increase in lending to the private sector, with a growth of between 30–40 percent during the period. The removal of foreign exchange controls, particularly on lending to non resident companies also supported the strong growth.

We are still in the second boom with a blip in 2008, as a result of the Global Financial Crisis followed by a depression in the developed countries that, led to economic problems all around the world. Price stability was achieved and maintained from 2004 to 2009, with the exception of 2008 and first half of 2009, due to high international food and fuel prices, which were beyond PNG's control. There was also prudent fiscal management in this period, except for 2008.

While it is too early to judge the outcome, we can point toward some improvements mainly in the formal structures. The Government has a Medium Term Development Strategy document 2005–2010, which has yet to be updated, a Medium Term Fiscal Strategy Document 2008–2012, enacted the Fiscal Responsibility Act 2006, and formulated the Development Strategic Plan 2010–2030, and the Papua New Guinea Vision 2050. These can serve as the framework for a clearly defined objective, which can be assumed to be, a Broad Based Economic Growth as measured by GDP, underpinned by a greater participation of and benefit for the rural people.

3. What are the development prospects of the construction and operation of a LNG Project?

The development prospects of the LNG project should be looked upon in two stages – construction and operation (production).

A. The construction stage

The construction stage will last three to four years, to the end of 2013 or even 2014. The size of this project at a total expenditure of US$ 15 to US$ 16 billion is huge by all standards. Just to give some general measures, the expenditure is 1.8 times the estimated nominal GDP of Papua New Guinea. It is far beyond what the country experienced in the past mineral developments and a magnitude that at least I don't know if there is a precedent of it in any other country. If we assume that construction will last for four years, every year the developer will spend the equivalent of 45% of the 2009 nominal GDP.

A large portion of the expenditure will be on imported goods and services, paid from funds held off shore while, some of the goods and services will be purchased on shore, with funds to be brought in from off shore. The size of the project coupled with the very strong impact it will have on domestic economic activity will facilitate activity in the other sectors of the economy such as food production in agriculture, manufacturing, building and construction,
and transportation. Those who will act for the LNG project will be paid by the developer converting foreign exchange into Kina, which will have the effect of an appreciated kina. The increase in imports to accommodate increase in economic activity in other sectors will have the effect of a depreciated kina. These opposite effects could balance each other out and result in a stable kina exchange rate. But this will depend on the magnitude of flows from each side. Even if the reserves might decline as a result of the imports by other sectors that are not for the project development, it will be marginal. The Bank of Papua New Guinea has sufficient reserves to ensure that it has minimal impact on the exchange rate and through it on inflation.

While it is expected that there will be very strong growth in economic activity during the construction phase, high demand for goods and service will have some inflationary effect. To ensure that there is economic growth while inflation is not too high, the Government has to follow some clearly designed policies.

The developer is constructing a huge infrastructure corridor from the Southern Highlands to Port Moresby. They will construct roads, a pipeline, bring in electricity, telecommunication, and meet social-community commitments in the villages where the corridor is passing through. The country's production capacity will be used far beyond its availability. The Government is therefore advised not to undertake any major infrastructure development project during the construction years of the project and not increase its general expenditure. It should instead concentrate its efforts on maintaining and improving the existing infrastructure that deteriorated in some areas to an unusable state.

The added advantage will be that all the resources of the Government can be concentrated on the priority areas of education, health, conservation of the environment and law and order.

In these three to four years the Government should undertake a full detailed review of its development agenda. All sacred cows should be slaughtered.

1. It should re visit the decentralization of Government responsibilities and review the Organic Law on Provincial and Local Level Governments to streamline channels of funding mechanism for rural areas;
2. It should clearly define what Government should and should not do. What should be fully privatized, what should be done by Public, Private Partnership, and what functions and roles should be abolished for enhancement and efficiency in service delivery;
3. It should set out clearly defined targets for social indicators in health, education, law and order and conservation of the environment; and
4. It should prioritize the infrastructure projects it will implement after the resources used by the developer become available when the construction phase ends. The Government should work out detailed plans for the highly skilled local contractors working on the LNG infrastructure, so that following the completion of the construction stage, it will use the resources elsewhere. This will ensure that there is no crowding out of the private sector and the benefit of using highly qualified contractors and workforce, to implement a long term infrastructure development framework can become a reality.

We at the Bank of Papua New Guinea also have to work on several matters during the construction phase of the project. These are:

1. The development and implementation of a national payments systems that will be geared toward dealing with instruments of a fully developed country with all the payment mechanisms used in today's world;
2. Ensure that financial services are available to the people "unbanked population" wherever they are, through developing the Microfinance industry and the rural banking facilities by all the banks and financial institutions operating in the country, telephone, including mobile phone and internet banking;
3. Enhancing competition in the banking and finance industry through licensing of new foreign exchange dealers such as FIFL, licensing of more micro banks such as the two new ones recently and licensing of Post PNG to do international remittances;
4. Expanding the banking services and products on offer by the banks in the domestic and foreign exchange markets; and
5. Creating a competitive environment to ensure that the people enjoy the best and lowest cost services, that a stable and prudently managed banking system can offer.

I will move now to the last part of my address.

4. What should be done to ensure that this time around we achieve our development objectives?

B. The production and operations stage of the LNG project

As I already said the three years 2006 to 2009 Papua New Guinea enjoyed a second mineral boom driven by high gold, copper and oil prices. The Government learned some of the lessons of the failure of the first boom in the 1990's and took measures not to repeat the same mistakes. It decided to use some of the excess revenue to repay domestic and off shore debt. This is equivalent to a Future Generation Fund. Reducing debt today reduces the burden on future generations when the debt becomes due.

It also decided to place some of the excess revenue in trust accounts to be used as a stabilization fund. This decision has had some flaws, the first is that the use of the funds were not tightly controlled and regulated by law. The second is that the funds were deposited with the commercial banks at a very low interest rate, and the Bank of Papua New Guinea has had to defuse them to ensure that the excess liquidity will not result in very high inflation, by using Central Bank Bills (CBB's), at a much higher interest rate cost to the benefit of the commercial banks. Just to give some indication of the magnitude of the cost to the Government and the people, the interest rate paid on the trust accounts by the commercial banks were bellow 1%, while the CBB's were placed at 5% and higher, and only this year it has come down to 4%. The amounts were very large, at the peak the trust accounts reached close to K4.6 billion and the CBB's issued were K4 billion. Every one of us can see how costly this was to the Government and the people of Papua New Guinea.

The third problem was that most of the trust accounts were aimed to be spent on development projects and there was and still is very limited implementation capacity, that result in non-efficient use of the funds and in some cases some of the funds were misused. The fourth and last issue I want to point out is the trust accounts offered a stabilization potential. They could be drawn down when the revenues decline. When it came to the test in the sharp decline of the commodity prices in 2008, it did not work. The Government incurred a relatively large deficit of K 479 million, which as expected has had an inflationary impact that resulted in a two digit level inflation of 11.2%.

The generally accepted paradigm by the Government and the Bank of Papua New Guinea is that, a very responsible fiscal management, which aims at a balanced budget, or at the worst case at a very low deficit, and a complementary monetary management with the main objective of price stability, defined as low inflation levels, which is a necessary condition for a long term, sustainable economic growth. If properly done, this can benefit the great majority of the population, living in the rural areas. For the Bank's part, we realize that with the first LNG project and the likelihood of more LNG projects, the economy will enter a new era of economic growth. In its formulation and conduct of monetary policy the Bank will carefully assess and evaluate the trade-off between higher economic growth and inflation so as not to discourage domestic economic activity and ensure inflation does not spiral out of control.

It is very encouraging that the National Executive Council (NEC) decided to set up a joint working group of very senior staff from the Department Treasury and the Bank of Papua New Guinea to asses and evaluate the applicability of the Sovereign Wealth Fund model, to prepare the country toward the times that the LNG project will move into the operation stage of production and export.

All the expectations are that when the LNG project will move to the operation stage, the country will benefit from very large taxation, dividend, and royalty incomes. It is of outmost importance that the mistakes of the late 1980's and 1990's are not repeated.

The Working Group is consulting with all the stake holders and get the best available advice, from domestic and international experts, to come up with the best structures known at the present to deal with large foreign exchange inflows.

The last thing we should do is not to preempt the Working Group's deliberations and recommendations. The whole Nation has a very strong interest and a lot at stake and we want to ensure that they come up with the best possible solutions to the two subjects they deal with; the stabilization of the fiscal operations of the Government and the Savings for Future Generations, from a project of immense size and importance to the future wellbeing of all our nation.

The Government in close cooperation and consultation with all economic sectors and civil society, has the time to carefully formulate, and design the implementation tools and mechanisms of its development strategies and plans, to ensure that we commence an era of high economic activity and growth for the nation's future generations.

Thank you.